SWS Growth Equity

As of April 25, 2023

Inception
March 1, 2018

Benchmark
Russell 1000 Growth Index

Portfolio Managers
Michael Parker, CFA & Kurt Grove, CFA

Strategy Objective

SWS Growth Equity seeks to create long-term capital appreciation by investing in companies across multiple industries that have the ability to maintain or take profitable market share.

Firm Overview

SWS Partners focuses on using technology to deliver contemporary asset management solutions to endowments, foundations, pensions, family offices, and high net worth individuals. We believe that by emphasizing the application of modern technologies, we can create broad efficiencies and deliver better outcomes to clients.

Additional Resources

Scan the above QR Code to read more Growth Equity strategy-related insights and research.

Audio version
available on Spotify

For the first quarter of 2023, SWS Growth Equity returned 15.80% net and 16.07% gross of fees, compared to 14.37% total return of the Russell 1000 Growth Index, our strategy's stated benchmark. The S&P 500 returned 7.50% over the same period. Further context to returns can be found on page 5.

Attempting to decipher whether the current composition of global macro noise makes for favorable conditions to invest capital is a peculiar exercise. Two highly skilled market participants trafficking in the same macro data can draw the exact same conclusions that a particular trend is bullish or bearish. Yet they both can turn around and deploy risk in their respective portfolios in polar opposite fashions. Both actions can be deemed the correct decision, even by the same investment committee that selected both managers. It's the asset allocation, and how each respective mandate fits within it, that's the ultimate arbiter of appropriateness.

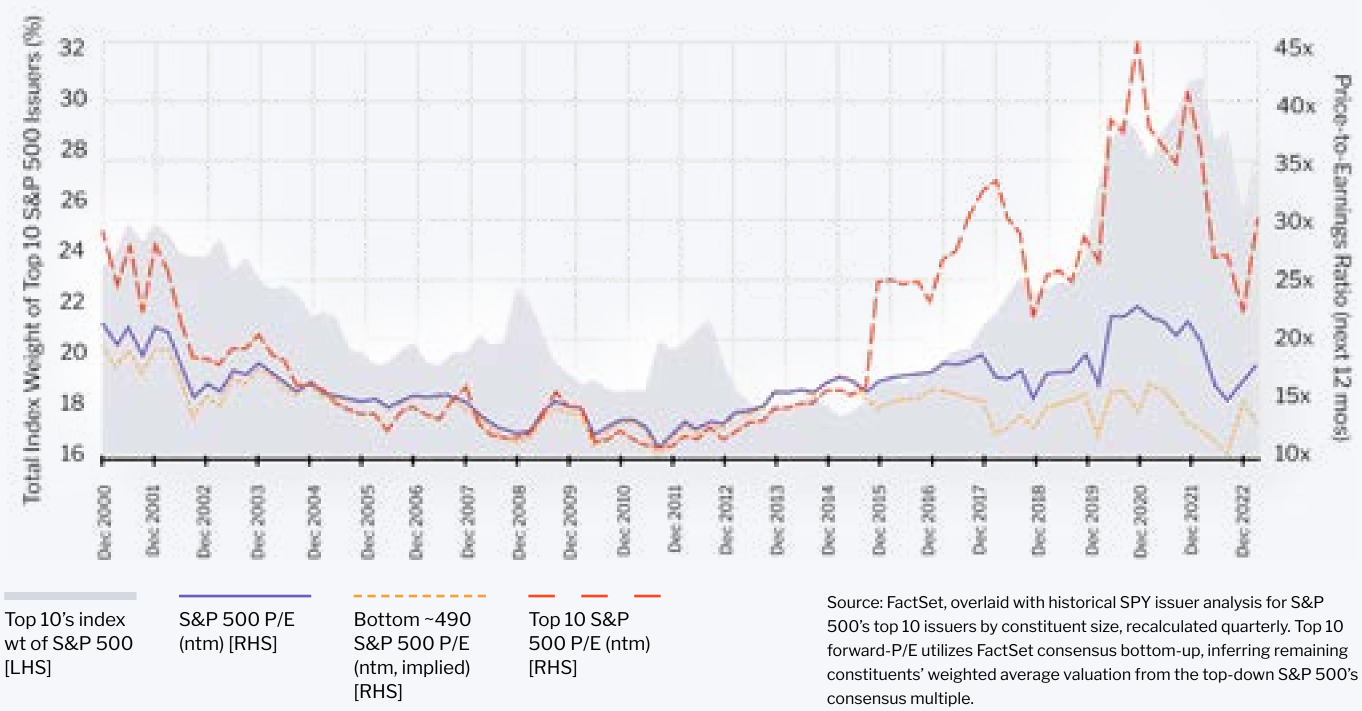
As long-only managers in US equity, we're only qualified to speak to investment process best practices within our asset class. The start of calendar 2023 is a salient reminder of the high price tag of rolling the beta-guessing dice within long-only capital. Having made a bearish read on our current macro backdrop, and translating that into wholesale defensive portfolio posturing would have just sidelined your portfolio from a double-digit market move. It's undoubtedly difficult to manufacture euphoria from any combination of current leading economic indicators. We highlight our macro read later, but the latest application of our relative value creation lens reveals an interesting crossroads to the current environment.

The multi-year-long tide of cheap money, one propping up thousands of bad business models, has unquestionably receded. It also should not be modeled to return in the foreseeable future within any reasonable business projections. The harsh new reality is a sun bearing down on many businesses that have yet to evolve their gills into lungs. The flip side of this coin, it creates a target-rich environment for uncovering opportunities, specifically geared for the task of determining which business models contain stronger odds of proving their land-worthiness. Not to mention from an active-versus-passive perspective, this makes the go-forward, multi-year period exceptionally compelling. Our broad market proxies' will be formulaically compelled to own the aggregate outcomes of the expiring masses indiscriminately. Our careful study of how all of this is likely to unfold in publicly traded equities leaves us increasingly optimistic about our ability to discriminate among this opportunity set.

For large-cap in particular, it may be less about going concern risk of issuers in this cohort. However, a different dynamic makes this part of the cap spectrum vulnerable to another flavor of risk, one just as dangerous to return generation. The narrowing of return participation has only worsened of late; in S&P 500 parlance, 98% of its YTD return was derived from its seven largest issuers. This caused its largest cohort to become pricier, valuation-wise , while the remaining majority got cheaper. As of March 31st, everyone outside of the S&P's top 10 (494 issuers in total) averaged 13.2x forward earnings. In contrast, its top-10 traded 30.6x. Combined, the two cohorts aggregated to an overall wtd. avg. index P/E of 18.1x, a level many would consider a far cry from reflecting elevated risks of a recession. Historically, such conditions merit low-teens forward-P/Es. The big take-home here, ~98% of issuers (by count rather than index weight) are basically already priced there. The "problem" is the skew from 29% of its cap weighting; an important side note: this is also a figure well above historical levels of influence (note the trend of gray area in chart 1 below).

Chart 1

Under the Hood of S&P 500 Valuation



Source: FactSet, overlaid with historical SPY issuer analysis for S&P 500's top 10 issuers by constituent size, recalculated quarterly. Top 10 forward-P/E utilizes FactSet consensus bottom-up, inferring remaining constituents' weighted average valuation from the top-down S&P 500's consensus multiple.

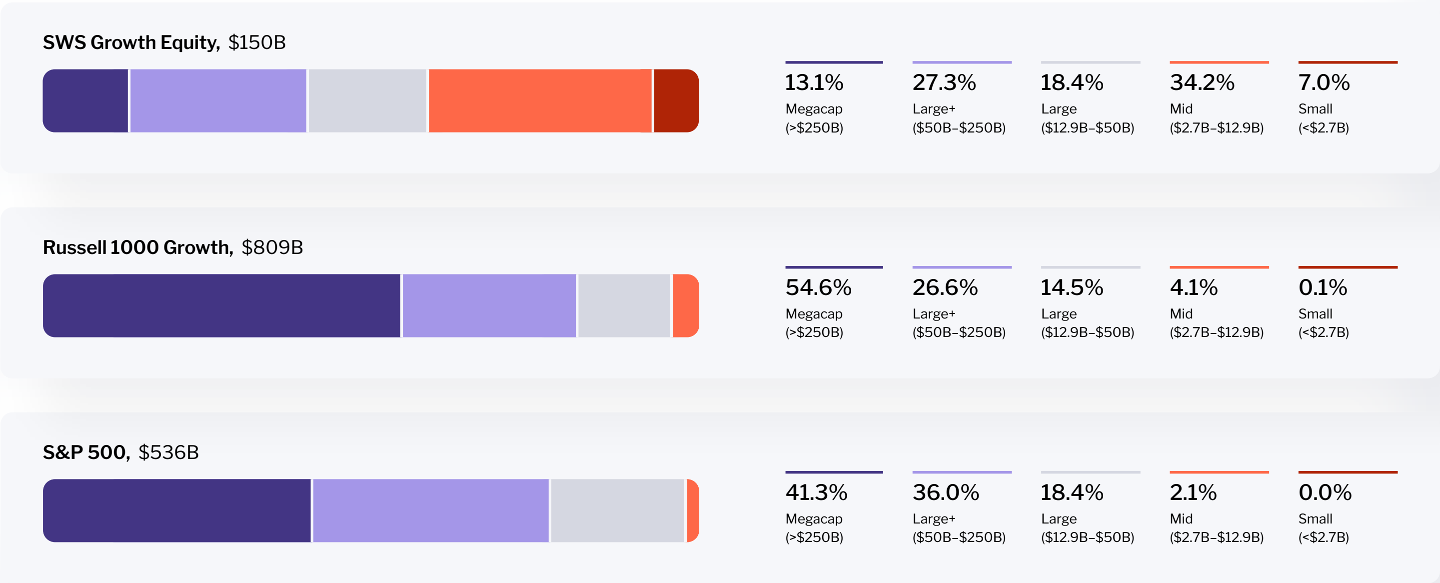
The eventual unwind of this concentration distortion will have an interesting impact in the actively managed space. The "flight-to-megacaps" has been a popular risk mitigation practice for many over the past few quarters, one enabled by nearly limitless issuer liquidity. Yet this is precisely where fund size can be highly detrimental. Pivoting from $1 trillion+ issuers into a basket of far less liquid $10-50 billion market cap issuers carries size and liquidity limitations for double-digit-billion dollar AUM portfolios (which are aplenty among large-cap growth equity). It also makes any meaningful hunting in the sub-$10 billion territory largely off-limits. Yet this is precisely where the most fruitful fundamental opportunities lie (i.e. our earlier tide-going-out discussion). We prefer retaining control of every driver to price discrepancy while exercising consummate adaptability to exploit all price dislocations from intrinsic value. To us, any other path is synonymous with outsourcing critical elements of the investment process to chance.

We'd respectfully submit that all of this warrants a modernized approach to large-cap investing. It also possibly requires revisiting the theorem that large-cap liquidity = lack of fundamental edge = lackluster alpha opportunities = passive allocation to the large-cap asset class. Most major data aggregators define large-caps as all companies north ~$12 billion in market capitalization, then subsequently call it day at specifying tiers above this level. However, the multi-year-long swelling of issuer concentration (back to chart 1) has had highly deterministic impacts on an investor's ultimate outcome. A manager with a $150 billion weighted average market cap portfolio—one squarely in the "large cap" peer group—has faced unique challenges compared with any others in the $400 billion+ club.

Page 5 walks through these tail/headwind dynamics in our performance discussion, while chart 2 below outlines our 1Q2023 market cap skew relative to both the Russell 1000 Growth Index and the S&P 500 Index.

Chart 2

Fading the Source of Distortion: Megacaps



Source: FactSet, Addepar. Weightings on right represent % of portfolio/index in each respective market capitalization tier; weighted average market caps are shown adjacent to each index name, all as of 3/31/2023.

The overall goal of our investment process is to hone a common framework by constantly calibrating it with fresh data on how companies generate economic value for their shareholders. Balance sheet intensity is a critical factor of our process, and this prior quarter saw increased utilization of its application (subsequently sharpening its acumen in the process). The second* greatest outcome of managing pension capital through the 2008/2009 global financial crisis ("GFC") is having a battle-hardened playbook on how systemic erosions of confidence can lead to bank failures. The modern application of this just happened to unfold over the course of one afternoon.

**The single greatest post-GFC outcome: successfully navigating our capital base through the other side without suffering irreparable casualties, while retaining critical lessons for future underwriting exercises.*

After a quick assembly of "Situation Room Sunday" over the weekend following SIVB and SBNY's collapse, we were able to ascertain that critical plumbing infrastructure was being brought back online. Prior to the GFC, all of these processes had to be built from scratch, while the market suffered multi-quarter-long contagion effects from what began as a finger-in-dike approach to propping up critical financial infrastructure.

However, a silver lining to that brink of disaster 15 years ago, our 2023 banking confidence restoration project could be erected over a weekend. Despite enduring the US's second-largest bank failure ever with SIVB's collapse, the FDIC projects to incur a net $3.3B loss, i.e. roughly just 2.6% of the deposit insurance fund that props up a nation's worth of insured deposits.

None of this is a declaration of being out of the woods, and we're not here to debate the merits of making uninsured depositors whole. It's also very possible that bank balance sheet duration risk (i.e. deposit funding having far shorter liquidity than the securities/loans that sit on the asset side) could very much morph into credit risk. Tools that allow cohorts of depositors to hit the exits simultaneously are also the toothpaste that's out of the tube. We expect a softening job market and further economic erosion to translate into higher delinquencies and ultimately charge-offs across various pockets of consumer credit. However, it's more likely that we will be able to contain the situation far better than what led to 507 bank failures over 2008-2014 or the ~1,000 lost during the 1980s Savings & Loan crisis. Thanks to a decade+ period where regulators forced our banks to stockpile retained earnings onto the equity side of their balance sheets, today we're on far better structural footing to absorb delinquencies that season into charge-offs. US banking regulatory Tier 1 capital ratios averaged 13.4% at the end of 2022, versus sub-10% in 2008. Plus, a March 2023 CPI headline print that marked its lowest since May 2021 is a good indication that the Fed's blunt tool for price stability should alleviate some pain infliction.

With economic output being a function of 1) labor force participation and 2) labor force productivity, 2023 has provided a critical glimpse of future potential step-function impacts to the latter. The technical experts closest to the core of innovations in large language models describe the era of AI as our modern "iPhone moment." However, truly disruptive opportunities in AI will likely stem from its various applications rather than one particular large language model that will rule them all (similar to our take on crypto, where deciphering blockchain/decentralized finance's impact carries more investing implications than speculating on the price of a particular token).

The "AI heard around the world" via ChatGPT represents a salient plot point for a map of the current capabilities of the technology. We only have to go back to 2012 to see how AlexNet was able to destroy its competition by correctly identifying 85% of randomly selected cat images as true positives. About a decade later, plain English text input from a user with zero software coding experience can instruct AI to render a photo-realistic image of a cat wearing a tuxedo, in the aesthetic of a van Gogh painting.

The composition of today's peanut gallery heckling at the narrow utility of this particular use case is similar to ones laughing at past finite addressable opportunities. It's very reminiscent of the dramatic criticism directed towards the perceived finite opportunity of selling paperback and hardcover books online in the late-90s; or that which was dismissive of how meaningful excess server capacity could become; today both ventures known as Amazon.com and Amazon AWS make these criticisms seem ridiculous in hindsight.

The Amazon [AMZN] analogy is a great one that risks being deemed overly simplistic. However, the critical question we ask ourselves in deconstructing AMZN as a business model is, how truly future-proofed would our strategy be if our investment process discarded AMZN as attractive at every point along its run to a $1 trillion company? Even fast-forwarding past the early near-death years and cherry-picking its more established years—e.g. the 10+ year span of forty earnings prints to dissect, where revenues swelled from $50B to $500B—if our process overlooked the cash flow generation potential the entire way, or dismissed it outright after thorough analysis, odds are decent that similar mistakes will be repeated in later cases with TSLA, NVDA, GOOGL, and MSFT.

Nailing how AI will be utilized by companies across the entire economic landscape is one of many important themes to study very carefully. We see it as the only way to calibrate an actively managed strategy capable of deciphering how value creation will occur across increasingly larger chunks of our investible universe. This pertains to both public and private companies. Given that neural network architectures are largely a brand-new concept, it requires deep dives into uncharted waters. By definition, these are areas outside of investors' comfort zones. Conclusions here require tasking capital to prove the masses are wrong, which is an exercise of the confidence of conviction despite the discomfort of being non-consensus.

This is precisely why, regardless of portfolio composition, we will be closely dialed into events like NVIDIA's GTC, Amazon AWS's re:Invent, Google I/O, Tesla's AI Day(s), Snowflake's Summit, and many other industry events that place us closest to the primary sources of how these innovations are developed and evolving. This is where building blocks to massive future market cap greenfields are laid, and, specifically with AI, the picture is starting to crystalize on business models caught flat-footed versus those in leadership positions. These are the exact conditions that make for ripe opportunities in our portfolio, both on relative and absolute fronts.

Raison D'être: Alpha Delivery

The first quarter of 2023 showed surprising strength at the index level despite a barrage of negative headlines split among bank runs and failures, recession fears, and negative earnings revisions. Headlined by the S&P 500 returning +7.5% in the quarter, a more thorough analysis shows a significant dispersion among sub-indices. Growth as a factor outperformed value, with the Russell 1000 Growth ("RLG") Index returning +14.4% relative to the Russell 1000 Value Index returning +1.0%. Market-cap was a key determinant in performance in the first quarter, as small and mid-caps underperformed, with the Russell 2000 returning +2.7% and Russell Midcap +4.1%, respectively.

Sector-wise, returns were equally dispersed, with Consumer Discretionary, Communication Services, and Technology all returning > +15%, while Financials, Utilities, Health Care, and Energy all fell > -3% for the quarter.

SWS Growth Equity outperformed in the quarter, returning +15.8%/+16.1% net/gross of fees, respectively, relative to the RLG's +14.4%. Our intentional decision throughout 2022 to concentrate our positions and increase weighing to our higher conviction ideas has shifted the portfolio to a lower market cap weighting, higher growth, and higher daily volatility than the overall market. This has caused a more significant deviation versus our stated benchmark, the RLG evidenced by our portfolio statistics versus the RLG: wtd. avg. market cap that is ~1/5th the RLG at $154.9B vs $817.8B, projected 5-yr sales growth of 30.5% vs 15.7%, and trailing price-to-earnings of 26.7x vs 37.6x. We see this as a prudent posture as the top 10 constituents in the RLG have become increasingly concentrated, making up 47% of the index with questionable fundamental support. We see more upside opportunities outside of these constituents.

Chart 3

SWS Growth Equity Performance as of 3/31/2023

	1Q2023	YTD	1-Year	3-Year *Annualized*	Since Inception *Annualized*	Since Inception *Cumulative*
SWS Growth Equity (net wtd. avg. fee)	15.80%	15.80%	-18.84%	10.94%	9.57%	56.74%
SWS Growth Equity (gross)	16.07%	16.07%	-18.12%	11.89%	10.48%	63.26%
Russell 1000 Growth	14.37%	14.37%	-10.90%	18.58%	13.69%	87.88%
Russell 1000 Value	1.01%	1.01%	-5.91%	17.93%	7.59%	43.27%
S&P 500	7.50%	7.50%	-7.73%	18.60%	11.24%	68.86%
Russell Midcap	4.06%	4.06%	-8.78%	19.20%	8.20%	47.34%
Russell 2000	2.74%	2.74%	-11.61%	17.51%	4.49%	24.11%
NASDAQ Composite Index	17.05%	17.05%	-13.28%	17.56%	12.60%	79.23%

Source: FactSet. Data represent total return (dividends reinvested into a respective index) for the period ending 3/31/2023. Please see important disclosures on page 12. SWS Growth Equity inception 5/1/2018.

Chart 4

Growth of $1 Million in SWS Growth Equity Since Inception

Above chart displays the value of a hypothetical $1 million investment in SWS Growth Equity since its May 1, 2018 inception, both on net of advisory fee and gross of advisory fee bases. These results are compared with broad-based indices, which do not include expenses and are shown on a total return basis with dividends reinvested.

Contributors & Detractors

The following analyses highlight the fundamental work underlying our investment process. Here we deconstruct the merits of the top contributors and detractors to portfolio performance on the quarter (with total return contributions listed):

Top Contributor

Meta

META Meta Platforms Inc **+76.1%**

META had a standout first quarter returning +76%, besting its software peers at +19%. Similar to our writings on Netflix in the third quarter, META represents a fallen-from-grace pandemic beneficiary experiencing a bounce-back of its own merit.

After peaking around ~$381/sh, or $1T market cap, in August of 2021, a barrage of negative news would hit META over the following quarters. IDFA headwinds, a global advertising slowdown, the rise of TikTok, an 80% reduction in 2023 free cash flow estimates, and questions over capital allocation due to metaverse spending all would plague META. This ultimately resulted in a crescendo of negativity on the third quarter 2022 call over concerns on the opex and capex guide, which caused the stock to fall ~25% on the day. All-in META dropped 76% from its pandemic-induced highs, falling to $88 a share, resulting in a flat return since early 2016 for investors.

This market was voting in real-time, and Meta was facing too many headwinds and the market posed the following hypotheticals: ***"it was going to lose to TikTok, revenue headwinds from IDFA and the transition to Reels were business model risks, and Mark Zuckerberg had lost his ability to lead".*** We needed to put on our proverbial "value-investor" hat and evaluate the company. After an 80% reduction in 2023 free cash flow estimates, Meta was trading at just 6x forward estimated FCF of $10.6B. This was a far cry from the $40B in FCF produced by the company in the prior 12 months. Investors were valuing the company like a cyclical commodity company, i.e. it traded at a lower valuation than Exxon at ~$90/barrel oil. Given the market tends to overshoot to the upside on irrational exuberance and to the downside on excessive fear, we saw this as an obvious example of the latter.

We deconstructed the main points of the bear's arguments: reels transition, TikTok threat, Zuckerberg as a leader. The transition to reels, while revenue dilutive, was necessary and should stem the attention share loss to TikTok. While we believe TikTok to be a far superior competitor to Snapchat, investors have seen this type of competitive threat before. Additionally, the China/TikTok connection should be a headwind for greater adoption (if it will ultimately be allowed to operate legally in the US over the coming decade). In the prior case of a competitive META response, the transition to stories from a scrolling feed was necessary to squash the threat from SNAP. The initial painful, revenue-dilutive transition to stories' had a dual effect: 1) Meta staved off Snapchat's market share advance, who has since been fairly limited in penetrating the >30-year-old demographic, and 2) stories are now revenue accretive relative to the singular scrolling feed. While painful in the short term, we believe the reels transition is positioned accordingly for the next evolution of social media.

As to Zuckerberg, we thought the market was rather loudly complaining about his capital allocation strategy, and he would be soon forced to listen to the market. This turned out to be the case very quickly, on November 9th Zuckerberg announced the first 11k of a total of 25k employees to be laid off, coinciding with a $5B reduction to capital expenditures.

We ultimately purchased META shares on November 7th @$95, and since this date, market estimates for 2023 cash flow have increased 74% to $18.5B, albeit still 54% below its rolling 12m high-watermark for cash flow.

Top Contributor

ARISTA

ANET Arista Networks, Inc. **+38.3%**

ANET returned +38.3% for the fourth quarter, outpacing its hardware peers at +32.1% in the first quarter. We most recently profiled Arista in the fourth quarter of 2021 as a contributor and will be brief in expanding on Arista this quarter.

Arista continues on its path of taking share from competitors Cisco and "white-box" solutions, as ANET now garners >20% share in the data center switch market, driven by its leadership solution within the cloud service providers. Arista's focus on driving a software-first approach via its EOS simplifies a customer's usage of network equipment regardless of the customer's use case -- campus, data center, routing, or software services.

Currently, Arista has competitive strangleholds in the cloud service providers market within Microsoft and Meta, both >10% customers. The rise of ChatGPT and other AI LLM applications bolstered the entire AI ecosystem from a stock performance perspective; semiconductors, cloud providers, and networking equipment providers all were bolstered from AI hype. While we expect to see some head fakes with the rise of AI as it traverses its respective "hype cycle" curve, we do think ANET is uniquely positioned to benefit and provide the IaaS players with their networking needs. It would not surprise us to see another major cloud provider (Alphabet or Apple) pick Arista to be its first major non-white box solution within the data center.

Top Contributor

natera

NTRA Natera, Inc. **+38.2%**

Top Detractor

GUARDANT

GH Guardant Health, Inc.**- 13.8%**

NTRA and GH are both companies that live in the liquid biopsy market. Currently, they bump up against each other as competitors in the MRD market and will compete in varying ways over the coming decade, but we expect the market to bifurcate and thought a combined analysis would be helpful. In oncology, Natera is presently commercially focused on a tumor-informed liquid biopsy approach to do serial monitoring, immunotherapy solutions, and pharmaceutical research, alongside its existing NIPT and transplant businesses. Whereas GH is primarily focused on a blood-only approach to the above commercial markets, with the additional market of pre-cancer detection.

We expect the liquid biopsy market to bifurcate into two distinct markets. The first is pre-cancer detection, which will be a blood draw that determines a positive probabilistic cancer detection, and then additional cancer-specific tests will be administered to determine a final diagnosis and treatment plan. If the cancer is a solid tumor and is removed, it will then be sequenced for monitoring. We expect this point to be the bifurcation point, where a tumor-informed approach, currently Natera is the leader here, is preferred because of the patient-specific tumor configuration of the liquid biopsy.

We last wrote about Natera in 1Q 2022 as a detractor, when a highly misleading short report afforded us the opportunity to purchase shares @$34, and we wrote about GH last quarter when it was a detractor after a disappointing trial readout from its

ECLIPSE trial. Respectively, NTRA returned +38.2% and GH returned -13.8% for the first quarter relative to both companies' pharmaceutical peers returning -1.0%.

In the first quarter, performance was very dispersed for these two peers because of the "margin of safety" of the two companies. GH is highly dependent on future FDA approval of its pre-cancer detection, Shield test. We went into detail last quarter on the specifics of the trial, why it was viewed negatively by the street, and why we think that is an overreaction. While progress was made by GH this quarter with FDA submission now complete and Medicare approval for immunotherapy monitoring, investors are forced to play the waiting game on FDA comments in order to get an early read on how positive or negative the agency views the ECLIPSE trial data. In an equity market where banks are failing and the funding environment is much tighter, a company dependent on this future approval (which we deem likely) is often put in the "too hard" pile by investors; a view we do not take but understand the investment will be accompanied with extra volatility.

Contrast this to Natera, which is not dependent on one singular approval and received positive news in its NIPT and oncology divisions this quarter. In the NIPT division, Natera received a positive recommendation for microdeletion screening by ACMG, a likely precursor to ACOG guideline changes and future reimbursements by insurance companies to cover microdeletion screening. We underwrite this specific opportunity, once covered by insurance, at ~$600M of incremental revenue with ~95+% incremental margins. Additionally, Natera received its newest Medicare coverage extension for its Signatera MRD test to include breast cancer monitoring. Breast cancer is the latest indication to be covered and adds an additional 1M of annual test coverage, a $3.5B opportunity that currently no other companies are approved to monitor. We balance these two positions with their relative upside and margins of safety by allocating 7.9% of the portfolio to the companies, with the lion's share allocated to Natera at a 6.2% position.

Top Detractor

UNH UnitedHealth Group. **-10.6%**

UNH, an original May 2018 Growth Equity position finds itself on the list of detractors for the first time after appearing as a contributor in the first and second quarters of 2022. UNH mildly underperformed its peers this quarter, falling -10.6% relative to its healthcare providers at -8.7%.

Many of the same fundamental merits for our original position in UNH still exist and have improved since. US demographics are a long-term tailwind due to the aging of the baby boomers, and price discovery between consumers (patients) and sellers (care providers) remains convoluted as ever. The secular trend towards telemedicine and electronic medical records are benefited by the acquisition of LHC, which formally closed in February.

We don't view the negative performance this quarter as anything fundamentally related, evidenced by peers performing essentially in-line for the quarter. A top performer in 2022, +7% versus the S&P 500 at -18.1%, we expected some mean-reversion for UNH and reduced our position in 2022 multiple times throughout the year to help redeploy into portfolio laggards. UNH as a position helps to barbell the risk profile within healthcare for the portfolio. As a lower beta, low earnings variability, high market-cap as a position it helps to balance the higher octane of aforementioned liquid biopsy issuers, NTRA and GH to generate higher risk-adjusted returns.

Top Detractor

RH.

RH RH -8.9%

Attempting to become the first luxury home furnisher at scale doesn't come without some bumps in the road. At initial underwriting in the first quarter of 2022, we expected a significant weakening of the housing market in the US, and subsequent purchases by us of the stock in the second half of 2022 took into account the company's projection of a very weak housing market. Unfortunately, we were early on the trough of the company's earnings revisions and did not factor in a down 45% luxury homes market and a down ~75% refinancing market. These macro headwinds caught up to RH this quarter and led to the -8.9% return, underperforming the consumer product peer set at +11.4%.

Acknowledging our early entry in RH we think our position is still warranted and presently trades at an attractive valuation. We think the most recent earnings guidance is excessively conservative and ultimately will be "trough" earnings. Looking at a longer-term earnings profile, RH trades at <10x mid-cycle EPS numbers off its current store footprint.

Longer term, the setup for RH is increasingly attractive. 56% of its U.S. store footprint is still the "legacy" gallery format and will be upgraded to the showroom format. At 5x the size, traffic increases 3x and product display increases 6x, while absolute rent payments are often lower after the sale-leaseback model RH utilizes. This proven format increased sales by 50-150% and led to the 73% ROIC posted in 2021. Moving away from the US, RH will open England in 2023 and has further international openings planned in Milan, Madrid, Munich, Dusseldorf, and Brussels in 2024 and 2025. This will be RH's first foray internationally with a dedicated footprint, where there have been no attempts by competitors to build a luxury brand at scale within home furnishings.

Portfolio Changes

New Positions	CIEN
Position Additions:	MP, PINS, PCT, PYPL
Position Reductions:	VC, WDAY, META, AMH, ANET, AMZN, ACN, NOW, ISRG, GOOGL
Position Exits:	None

New Positions

CIEN Ciena Corporation

Ciena is our newest position in the portfolio, representing a constituent within the hardware subsector of technology, joining Arista as our respective offset to not owning Apple (~13% of the index, trading at 26x forward P/E heading into a tough consumer computing environment). CIEN is a leader in the optical networking space, providing hardware, software and services that enable the delivery of video, data and voice traffic to communication service providers, cable operators, Web-scale providers, governments, and enterprises.

While many networking-related issuers had strong demand pull-forward through the pandemic period and consequently strong stock moves, CIEN was left out of both. Appreciating just 8% since its July 2019 high, CEIN underperformed the S&P 500 by 38% and Arista by 131%, and its revenue essentially has been flatlined since 2019. Concerns for CIEN have been building throughout the pandemic as its backlog has ballooned from ~$1B to >$4B; traditionally this has been the kiss of death in networking with the build of backlog as a sign that the cycle was overheated, double ordering was occurring, and that it was time to sell the stock. In this instance, the stock never materially appreciated amid concerns that this backlog would never come to fruition.

We're taking the other side of this, the reason for this ballooning of inventory was more so due to industry supply constraints and not the sign of a one-time cycle/pandemic boost. Historically the optical industry has grown around 6% CAGR, driven by a ~25% CAGR for data growth, offset by price declines. This equation has translated into significant underperformance for CIEN over the last four years because of supply challenges and customers running their networks at max capacity. This dynamic will revert in the next couple of years with CIEN expecting to grow 10-12%, the delta explained by share gains over competitors. We think this could be conservative for a few reasons. The combination of FTTH buildouts in the US, a $6B growing to $14B market, and U.S. and European tax subsidies for broadband deployments, a $150B buildout, represent significant opportunities for CIEN. Additionally, internationally there are opportunities centered around the $23B revenue that is generated outside of China by Huawei as countries move to distance themselves from Chinese network providers; and Reliance Jio outlined a $25B capex buildout plan in India where CIEN enjoys considerable market share.

Summing this all together, CIEN is trading at 14x forward earnings, below its historical average of 17x, and versus hardware peers at 26x, while CIEN should grow revenue >20% and earnings ~50% versus peers struggling to show growth, all of which sets up the stock for a strong relative and absolute investment opportunity.

Michael Parker, CFA Partner, Chief Investment Officer

Michael Parker, CFA, is the CIO of SWS and lead portfolio manager for the SWS Growth Equity strategy. Before joining SWS in 2017, Mike was a portfolio manager of $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS). He leverages over twenty years of experience on both the buy-side and sell-side to bring an institutional research and portfolio management framework to SWS Partners. Prior to OPERS, Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in economics, finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

Kurt Grove, CFA Partner, Portfolio Manager

Kurt Grove, CFA, is a portfolio manager for the SWS Growth Equity strategy. Before joining SWS in 2020, Kurt was an analyst on the internal active long-only US equity portfolios at Ohio Public Employees Retirement System (OPERS). He leverages over eight years of experience on the buy-side and in risk management to bring an institutional research and portfolio management framework to SWS Partners. Prior to OPERS, Kurt was responsible for Quantitative Risk Management at Key Bank. He received his Bachelor of Science in business administration, finance concentration, from the Fisher College of Business at The Ohio State University and is a CFA® charterholder.

Important Disclosures